July 24, 2003

IN RE: DOCKET NO. 2002-367-C & 2002-408-C

COPY OF **DIRECT TESTIMONY OF DENNIS B. TRIMBLE FILED ON BEHALF OF VERIZON SOUTH, INC.** HAS BEEN DISTRIBUTED TO THE FOLLOWING:

_____
McDaniel, Chief

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Legal Dept. (1)

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F. Belser

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P. Riley

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J. Spearman

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Exec. Director

_____
Manager, Utils. Dept.

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Audit Dept. (1)

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Regulatory & Governmental Affairs

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July 23, 2003

Mr. Gary E. Walsh
Executive Director
SC Public Service Commission
P.O. Drawer 11649
Columbia, SC 29211

In Re: Docket 2002-367-C & Docket 2002-408-C

Dear Mr. Walsh:

Enclosed you will find twenty-five (25) copies of the Direct Testimony of Mr. Dennis B. Trimble which is being filed on behalf of Verizon South Inc. in the above referenced dockets which were combined by the Commission for hearing purposes.

Please be advised that the Parties of Record have been provided a copy of same as indicated on the attached Certificate of Service. Please advise should you have any questions or require additional information.

Respectfully,

Wanda R. Rodgers (for)
STAN J. BUGNER
State Director

C: Steven W. Hamm, Esq.
Parties of Record

Regulatory & Governmental Affairs

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Mr. Gary E. Walsh
Executive Director
SC Public Service Commission
P.O. Drawer 11649
Columbia, SC 29211

In Re: Docket 2002-367-C & Docket 2002-408-C

Dear Mr. Walsh:

Verizon South Inc. filed the Direct Testimony of Mr. Dennis B. Trimble on July 23, 2003 in the above referenced Dockets. This letter is to correct the Certificate of Service that accompanied the filing of July 23, 2003. Ms. Kay Berry representative for ALLTEL of South Carolina, Inc. was left off of the Certificate of Service in error. Please find attached, a corrected Certificate of Service. She has been provided a copy of the Testimony as well as ALLTEL's attorney, Mr. Robert Coble, Esq. via electronic mail. .

Verizon apologizes for this oversight and any inconvenience this may have caused.

Respectfully,

Stan J. Bugner

STAN J. BUGNER
State Director

C: Steven W. Hamm, Esq.
Parties of Record

BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

IN RE:

DOCKET 2002-367-C - Generic Proceeding to Address "Abuse of Market Position")
)

DOCKET 2002-408-C – Generic Proceeding to Define The Term "Inflation-Based Index")
)

CERTIFICATE OF SERVICE
(Revised 07/24/2003)

This is to certify that I have caused to be served this day, one (1) copy of the Testimony of Mr. Dennis B. Trimble which is being filed on behalf of Verizon South Incorporated in the above referenced dockets by placing a copy of same in the care and custody of the United States Postal Service, first class postage prepaid to the following Parties of Record:

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WANDA R. RODGERS

July 24, 2003
Columbia, South Carolina

Legal - 1

BEFORE THE
PUBLIC SERVICE COMMISSION
OF SOUTH CAROLINA

GENERIC PROCEEDING TO ADDRESS THE DEFINITION OF "ABUSE OF MARKET POSITION"	)	**Docket No. 2002-367-C**
GENERIC PROCEEDING TO DEFINE THE TERM "INFLATION-BASED INDEX"	)	**Docket No. 2002-408-C**

DIRECT TESTIMONY OF

DENNIS B. TRIMBLE

ON BEHALF OF

VERIZON SOUTH INC.

JULY 23, 2003

TABLE OF CONTENTS

SECTION I: INTRODUCTION

Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND TITLE.

A. My name is Dennis B. Trimble. My business address is 600 Hidden Ridge, Irving, Texas, 75038. I am employed by Verizon Services Group Inc. as Executive Director – Regulatory. I am representing Verizon South Inc. and Verizon South Carolina (collectively "Verizon" or the "Company") in this proceeding.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. I received an undergraduate degree in business and an MBA from Washington State University in the early 1970s. I then served as an Assistant Professor at the University of Idaho, where I taught undergraduate courses in statistics, operations research, and decision theory. From 1973-76, I completed course work towards a Ph.D. degree in business at the University of Washington, majoring in quantitative methods with minors in computer science, research methods, and economics.

I joined GTE Corporation in 1976 as an Administrator of Pricing Research for General Telephone Company of the Northwest. From 1976 until 1985, I held various positions within GTE Northwest and GTE Service Corporation in the areas of demand analysis, market research, and strategic planning. In 1985, I was named Director of Market Planning for GTE Florida Incorporated (GTE-FL), and in 1987, I became GTE-FL's Director of Network Services Management. In 1988, I became Acting Vice President –

Marketing for GTE-FL. From 1989 to 1994, I was the Director of Demand Analysis and Forecasting for GTE Telephone Operations. In October 1994, I became Director of Pricing and Tariffs for GTE Telephone Operations, and in 1996, I was named Assistant Vice President of Marketing Services. In February 1998, I assumed the position of Assistant Vice President - Pricing Strategy for GTE Service Corporation. I assumed my current position in September 2000. In my current position, I am responsible for developing regulatory policies and supporting those policies before state commissions and the Federal Communications Commission ("FCC").

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE STATE REGULATORY COMMISSIONS?

A. Yes, I have testified on pricing issues, customer demand related issues, and general policy issues on behalf of various Verizon Communications telephone companies before state commissions in Alabama, California, Florida, Hawaii, Illinois, Indiana, Missouri, Oregon, Pennsylvania, South Carolina, Texas, Virginia, and Washington.

Q. WHAT IS THE PURPOSE OF THIS PROCEEDING?

A. The purpose of this proceeding is twofold. First, it is intended to define the phrase "abuse of market position" within the meaning of S.C. Code Ann. Section 58-9-576 and to establish criteria for determining what constitutes an "abuse of market position." Second, it is intended to define the phrase "inflation-based index" for purposes of local rate increases under Section 58-9-576.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is also twofold. First, it is intended to help the Public Service Commission of South Carolina ("Commission") properly define the phrase "abuse of market position" and to establish economically rational criteria for determining whether a firm's pricing activities constitute an "abuse of market position." Second, it is intended to help the Commission properly define the phrase "inflation-based index."

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The phrase "abuse of market position," as used in Section 58-9-576, should be construed to mean anticompetitive conduct that results from predatory pricing and/or bundling.

The phrase "inflation-based index," as used in Section 58-9-576, should be given its plain meaning – *i.e.*, an index based on inflation – and the Commission should employ the Gross Domestic Product Chain-Type Price Index ("GDP-CPI") to adjust telecommunications prices.

Q. HOW IS YOUR REMAINING TESTIMONY ORGANIZED?

A. The remainder of my testimony is set forth in two sections. Section II addresses the definition of the phrase "abuse of market position" and the criteria that the Commission should use to evaluate "abuse of market position" complaints. Section III addresses the definition of the phrase "inflation-based index."

SECTION II – ABUSE OF MARKET POSITION

Q. WHAT IS THE CORRECT INTREPRETATION OF THE PHRASE "MARKET POSITION" AS IT IS USED IN SECTION 58-9-576?

A. Because this statute concerns incumbent local exchange carrier ("ILEC") pricing activities, the phrase "market position" should be construed to mean "dominance in the marketplace" or "dominant position."

Q. IS THERE A COMMON ECONOMIC UNDERSTANDING OF THE PHRASE "ABUSE OF DOMINANT POSITION?"

A. Yes, this phrase has a well-established meaning.[1] It refers to the conduct of a dominant firm that harms the competitive process (i.e., anticompetitive conduct). Domestic and foreign laws that are designed to prevent "abuse of market position" are concerned about harm to the "competitive process"; they are not specifically concerned about harm to competitors.

Q. WHAT TYPES OF CONDUCT COULD POTENTIALLY BE CONSTRUED AS AN ABUSE OF DOMINANT POSITION?

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[1] *See, e.g.*, "Enforcement Cooperation among Antitrust Authorities," speech by John Parsi, U.S. Federal Trade Commission, before the IBC UK Conferences Sixth Annual London Conference on EC Competition Law, May 1999 (updated October 2000), viewed at http:/www.ftc.gov/speeches/other/ibc99059911update.htm ["... whether described as *abuse of dominant position* (as in EU law) or monopolization (as in U.S. law).]" (Emphasis added).

A. There are three basic types of conduct that are commonly alleged to be an abuse of an ILEC's purported dominant position:

1. Predatory Pricing: pricing below cost such that the firm harms its own profitability (in the short-run) in an attempt to harm (or exclude from the market) other equally efficient competitors.
2. Price Discrimination: not offering purchasers the same prices for the sale of commodities of like grade and quality as have been offered to other similar purchasers. Generally, price discrimination is deemed to be abusive only if it substantially lessens competition or tends to create a monopoly in any line of commerce.
3. Bundling: requiring buyers to purchase a bundle of separable competitive products. This is not a relevant consideration in this case as all of the services contained in Verizon's bundled offerings are also available separately.

Q. IS IT REASONABLE TO ASSUME THAT THE PHRASE ABUSE OF MARKET POSITION, AS USED IN SECTION 58-9-576, WAS INTENDED TO COVER EACH OF THE THREE TYPES OF CONDUCT DISCUSSED ABOVE?

A. No. It is unlikely that this phrase was intended to cover price discrimination because price discrimination is specifically and separately addressed in Section 59-9-576.

Q. HOW ARE CONCERNS OF "ABUSE OF MARKET POSITION" OR "ANTICOMPETITIVE CONDUCT" ADDRESSED IN ANTITRUST LAW?

A. U. S. antitrust law interprets "abuse of market position" as a potential type of monopolization offense prohibited by Section 2 of the Sherman Act (a "Section 2 violation"). To demonstrate a Section 2 violation, a firm must be found to:

1. have a dominant market position; and

2. exhibit market conduct that is "abusive" (i.e., exclusionary).[3]

Section 2 of the Sherman Act does not condemn the existence of a firm with a dominant position, as long as the dominant position was lawfully achieved. Instead, it is the combination of a dominant position and deliberate anticompetitive conduct intended to attain or preserve its dominant position that is considered an abuse or an antitrust violation.

1. *Price Increases*

Q. DO PRICE INCREASES BY A FIRM WITH A DOMINANT POSITION CONSTITUTE AN ABUSE FROM AN ANTITRUST PERSPECTIVE?

A. No. Price increases are not evidence of "exclusionary" or "abusive" market conduct.[4] As antitrust scholars Phillip Areeda and Herbert Hovenkamp explain, a firm with a dominant

[3] *United States v. Grinnell Corp.*, 384 U.S. 563 (1996) ("The offense of monopoly power under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.")

position does not impair the opportunities of its rivals or behave in an exclusionary manner when it increases prices. "On the contrary, high prices encourage the entry and expansion of rivals."[5]

2. *Predatory Prices*

Q. WHAT CRITERIA SHOULD THE COMMISSION EVALUATE TO DETERMINE IF AN ILEC'S PROPOSED PRICES ARE "PREDATORY"?

A. Based on antitrust practice applied to predatory pricing claims, there are two necessary criteria for pricing conduct to be considered predatory:

1. a firm must be setting its price below some measure of its incremental cost; and

2. there must be a reasonable likelihood that a firm's predatory pricing can exclude its competitors, and subsequent to its competitors' exclusion, the firm must be able to raise its price to recoup the losses by earning monopoly profits.[6]

[4] *See* Phillip E. Areeda and Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and their Application*, New York: Aspen Law and Business, Section 720a (2002) ("Areeda and Hovenkamp").

[5] Id.

[6] Areeda and Hovenkamp, Section 725b.

Q. PLEASE ELABORATE ON THE FIRST CRITERION OF A PREDATORY STRATEGY.

A. For a price to be considered predatory, it must be below incremental cost. If a price were above the carrier's incremental cost, it would not exclude an equally efficient competitor. The law makes clear that regulators should not seek to protect inefficient competitors at the expense of the competitive process.

Q. PLEASE EXPLAIN IN MORE DETAIL THE EXCLUSION AND RECOUPMENT CRITERION OF A PREDATORY STRATEGY.

A. Economists and courts have long recognized that attempts at predatory or exclusionary pricing are rarely successful because of the difficulty of recouping forgone profits that were incurred during the period of exclusionary pricing.[7] If the firm cannot recoup these losses, the pricing strategy can only harm, rather than benefit, the firm adopting it. Recouping losses requires that the firm be able to set prices substantially above costs for an extended period of time after successful exclusion. This requires that the firm have the ability to set high retail prices and erect sufficient entry barriers that these high retail prices would not induce (re)entry. In practice, these circumstances have not often been found in unregulated markets, and the regulatory requirements for retail as well as interconnection, unbundling, and resale (all at regulated rates imposed on ILECs) under

[7] *See, e.g., Matsushita Electric Industrial Co. v. Zenith Radio Corp*, 475 U.S. 574 (1986) (The success of any predatory scheme depends on *maintaining* monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain. Absent some assurance that the hoped-for monopoly will materialize, *and* that it can be sustained for a significant period of time, "[t]he predator must make a substantial investment with no assurance

the Telecommunications Act of 1996 ("96 Act") ensure this cannot happen in the local telecommunications markets in the United States.

3. *Bundling*

Q. DR. SPEARMAN, TESTIFYING ON BEHALF OF THE PSC STAFF, CONTENDS THAT "PRODUCT BUNDLING AND TIE-IN SALES" SHOULD BE OF CONCERN TO THE COMMISSION.[8] WHAT CRITERIA SHOULD THE COMMISSION USE TO EVALUATE WHETHER ANY SUCH ACTION ON THE PART OF AN ILEC WOULD CONSTITUTE ANTICOMPETITIVE CONDUCT?

A. Bundled service offerings are becoming the norm in the competitive telecommunications marketplace. Therefore, ILECs should be permitted to bundle together any services for which they believe there is a commercial demand. This would include bundles of regulated services and bundles of regulated and non-regulated services.

To expeditiously determine whether a specific bundled service offering constitutes anticompetitive conduct, the Commission need only answer two simple questions:

1. Can the services in the bundle be purchased on a separated basis?
2. Is the price (or implied price) for the regulated services in the bundle non-predatory?

If the answer to both of these questions is "yes", then the offering is not an exercise of anticompetitive conduct.

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that it will pay off." For this reason, there is a consensus among commentators that predatory pricing schemes are

If the answer to either of the questions is "no," then the Commission must determine whether the bundled offering will distort the "competitive process." If the bundled offering will not distort competition, then the bundle does not constitute anticompetitive conduct.

B. *Market Power*

Q. THE CONSUMER ADVOCATE'S COMPLAINT THAT GAVE RISE TO THIS PROCEEDING ALLEGED THAT BELLSOUTH COMMITTED AN ABUSE OF MARKET POSITION BY PROPOSING TO RAISE VARIOUS RATES. UNDER YOUR DEFINITION OF ABUSE OF MARKET POSITION, WOULD BELL SOUTH'S CONDUCT CONSTITUTE AN ABUSE OF MARKET POSITION?

A. No. Raising rates does not constitute anticompetitive conduct. It bears mention that Bell South's conduct would not violate Dr. Spearman's definition of "abuse of market position" because rate increases would not "effectively prohibit[]a new firm from entering the market."

Q. IN YOUR TERMINOLOGY, WHAT ABUSE WAS THE CONSUMER ADVOCATE ALLEGING IN ITS COMPLAINT REGARDING BELLSOUTH'S PROPOSED PRICING?

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rarely tried, and even more rarely successful.) (emphasis in original)

A. The Consumer Advocate alleged that "... there is a lack of a competitive alternative to control BellSouth's pricing behavior. In a truly competitive market, the Company [BellSouth] would be unable to sustain such price increases without a loss of significant business."[9] In my terms, the Consumer Advocate was alleging an abuse of market power, which the U.S. Department of Justice ("DOJ") and the U. S. Federal Trade Commission ("FTC") define as profitably maintaining prices above competitive levels for a significant period of time.[10]

Q. SHOULD YOUR PROPOSED DEFINITION FOR "ABUSE OF MARKET POSITION" (I.E., ANTICOMPETITIVE CONDUCT) BE AMENDED TO INCORPORATE ABUSE OF MARKET POWER CONCERNS?

A. No. The South Carolina telecommunications marketplace is sufficiently structured (i.e., effectively competitive) to obviate any ILEC ability to abuse market power in the pricing of non-basic services. If the Commission determines that concerns regarding potential abuse of market power should be incorporated into the definition of "abuse of market position", then I offer the following comments.

Q. WHAT CRITERIA SHOULD THE COMMISSION EVALUATE TO DETERMINE WHETHER OR NOT AN ILEC'S PROPOSED PRICING REPRESENTS AN ABUSE OF MARKET POWER?

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[8] Dr. Spearman's Direct Testimony at 8:1-2.

[9] *In the Matter of Philip S. Porter – Consumer Advocate for the State of South Carolina v. BellSouth Telecommunications, Inc.*, Complaint, page 2 (July 5, 2002) ("Consumer Advocate's BellSouth Complaint").

A. From an economic perspective, there are two basic conditions that must be satisfied for a firm to abuse market power: (1) there must be insufficient existing substitutes for the firm's product; and (2) entry into the relevant market by new firms (or through "product extension" by existing firms) must be difficult. If these conditions are not met, the firm will not have the capability to abuse market power.

Q. WHAT STEPS ARE TYPICALLY EMPLOPYED IN AN ANALYSIS OF MARKET POWER?

A. Following the approach outlined in the DOJ and FTC's Merger Guidelines, an analysis of market power involves two tasks. The first task is to define the relevant market, which is described by a product or group of products and a geographic area.[11] Briefly, this first task focuses solely of demand-side factors such as the range of reasonable substitutes in the market. What is critical in this determination and what antitrust courts have recognized is that the ultimate determination of whether products are competitive substitutes is whether they "have the ability – actual or *potential* – to take significant amounts of business away from each other."[12]

The second task involves a determination of whether the firm (or combined firm if a merger is being evaluated) can engage in an abuse of market power in the relevant market. This task concentrates on supply-side factors such as the existence of

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[10] DOJ and FTC, "Horizontal Merger Guidelines," issued April 2, 1992, revised April 8, 1997 ("Merger Guidelines"), Section 1.0.

[11] Merger Guidelines, Section 1.0.

competitive substitutes and the ease of entry and expansion into the relevant market.[13] It is commonly agreed that the availability of acceptable product substitutes prevents any abusive exercise of market power even when barriers to entry exist. Likewise, when there are no appropriate substitutes available for a firm's products, a firm does not necessarily have the ability to exercise an abuse of market power. When entry into the relevant market is easy, the threat of entry serves to block the formation and exercise of abuse of market power.

1. *Market Power Information*

Q. WHAT GENERAL INFORMATION IS RELEVANT IN EVALUATING ALLEGATIONS OF ABUSE OF MARKET POWER?

A. Once the relevant market is defined, the major factors of interest concern the competitive make-up of the relevant market. As I previously stated, there are two basic conditions that must exist for a firm to abuse market power: (1) a lack of competitive product substitutes and (2) barriers to entry in the relevant market. Accordingly, the basic information of interest in a market power study would likely include:

1. Ease of entry

a. list (or number) of competitive firms currently offering substitutable services

b. expansion capabilities (including current and uncommitted competitive firms)

[12] *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056, 1063 (3rd Cir.), *cert. denied*, 439 U.S. 838 (1978).

c. entry barriers (if any exist)

2. Substitutable product offerings

a. pricing information

3. Market shares (if available)

4. Competitive firms' customer addressability capabilities

a. percent of customers (or service revenues) in the relevant market that are easily addressable by competitive service providers.

Depending on the product (which may be a group of services) being evaluated for potential abusive market power conduct, the information requirements may vary. For example, if the relevant market is highly un-concentrated (or the firm of interest has a low market share), the relevant market can easily be assumed to be sufficiently competitive to prevent the subject firm from abusing market power.

(a) Market Share

Q. DOES THIS MEAN THAT MARKET SHARE IS A PRIMARY DETERMINANT OF MARKET POWER?

A. No. In a market with no significant barriers to entry, a firm cannot exercise market power regardless of its market share. The DOJ and FTC recognized this fact when they stated: "market share and concentration data provide only the starting point for analyzing the competitive impact of a merger."[14]

(Emphasis added.)

Low market shares are indicative of a lack of significant market power, but high market shares are not necessarily indicative of the existence of market power. The influence of high market shares in market power determinations is accurately explained by the following quote:

> Though not sufficient for a finding of market power, high market shares are likely necessary for such a finding. Whether market shares are reflective of market power *depends on barriers to entry.*[15] (Emphasis added)

Thus, a high market share can be indicative of market power *only if barriers to entry exist.* When barriers to entry do not exist (as in the case when unbundled network elements and/or facility-based networks are available), measures of market share provide no probative value in the determination of market power.

(b) Lerner Index

Q. DR. SPEARMAN STATES THAT THE LERNER INDEX COULD BE USED AS A MEASURE OF MARKET POWER.[16] PLEASE COMMENT.

A. Like market share, which has been used as a screening device to evaluate the potential for abuse of market power, the Lerner Index (which makes a comparison of price to marginal cost)[17] ignores the critical factors needed to determine the existence of

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[13] Merger Guidelines, Section 1.3.

[14] Merger Guidelines, Section 2.0

[15] Jeffrey Church and Roger Ware, Industrial Organization, McGraw-Hill, p. 604 (2000).

[16] Dr. Spearman's Direct Testimony at 8:9-13.

[17] The Lerner Index ("L") is computed as (Price – Marginal Cost) / (Price). In the world of a theoretically perfectly competitive market where price equals marginal cost, L = 0. Economic theory states that when L>0, the firm possess some degree of market power (which is virtually true for all non-theoretic firms. The maximum value for L is 1.0 (when marginal cost is 0.0)

significant market power – the lack of substitutes combined with high barriers to entry. As one antitrust practitioner at the FTC has noted, "[t]he main theoretic difficulty is that the Lerner Index does not offer a competitive benchmark except in perfectly competitive markets, where the Lerner Index should be zero."[18] In other words, there is no critical level of the Lerner Index to indicate when a potential abuse of market power may occur.

Using the Lerner Index as a measure of market power is particularly inappropriate in the telecommunications industry. In the telecommunications industry, one would expect the Lerner Index to be significantly higher than zero because (1) firms do not recover their total costs by employing margin-cost pricing tactics and (2) price structures are replete with subsidized services and universal service support flows.

Accordingly, the Lerner Index should not be used as a measure of market power.

2. *Recommendations Regarding Market Power Issues*

Q. DO YOU HAVE ANY GENERAL RECOMMENDATIONS FOR THE COMMISSION REGARDING MARKET POWER EVALUATIONS?

A. The South Carolina telecommunications marketplace is sufficiently competitive that firms cannot abuse market power, so the Commission should not waste resources addressing this issue. If the Commission nevertheless wishes to delve further into this

[18] Michael S. McFalls, U.S. Federal Trade Commission, "The Role and Assessment of Classical Market

issue, it should focus only on those criteria that are truly relevant to the inquiry -- existence of substitutes and ease of market entry – and disregard all other criteria.

Market power investigations should be streamlined to avoid examination of irrelevant criteria and to promote speedy and sound resolutions. As the California Public Utilities Commission ("CPUC") has stated regarding market power presentations:

> To require a mindless submission of extensive data of every single [possible market power] criteria would defeat one of the very goals our policies on Re-categorization of services seek to meet – permitting carriers the ability to change prices of services offered in competitive markets in response to market conditions in a timely way.[19]

Therefore, if the Commission intends to conduct market power investigations, which it should not, I strongly recommend that it focus solely on the existence of substitute services and ease of entry.

3. ***Regulatory Oversight of Competitive Pricing Proposals***

Q. IF THE RELEVANT MARKET IS OPEN TO COMPETITION, IS RETAIL PRICE REGULATION NECESSARY?

A. No. If the market is deemed to be competitive, the maintenance of retail price regulations is both unnecessary and undesirable. It is unnecessary because markets

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Power in Joint Venture Analysis," Staff Discussion Draft (October, 1997). The Lerner Index section of paper viewed at http://www.ftc.gov/opp/jointvent/classic3.htm.

function more effectively than can regulations to protect customers. This point is particularly apt given that the Commission retains the authority to regulate the interconnection and unbundling of the incumbent's network. It is undesirable because artificial regulatory restrictions are not innocuous in competitive markets. As the FCC has opined:

> [R]egulation imposes costs on carriers and the public, and the costs of delaying regulatory relief outweigh any costs associated with granting that relief before competitive alternatives have developed to the point that the incumbent lacks market power.[20]

By artificially preventing or hindering providers from quickly raising, lowering, restructuring, targeting, bundling, or otherwise changing prices, providers are impeded in their ability to respond to competition, to differential cost conditions, to customer-specific demands and preferences, and to changing market conditions. Moreover, the incumbent is prevented from correcting prices that have been distorted by years of regulatory oversight. If the incumbent cannot price in response to these legitimate market factors, it is restricted in its ability effectively to meet customer demand, and customers suffer.

4. *Comments Regarding the Consumer Advocate's BellSouth Complaint*

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[19] In the Matter of the Application of Pacific Bell to Re-Categorize Business Inside Wire Repair, CPUC Decision D.99-06-053 (1999), mimeo, p. 13.

[20] Access Charge Reform Order, para. 90.

Q. DO YOU HAVE ANY CONCERNS WITH THE CONSUMER ADVOCATE'S COMPLAINT THAT ALLEGED THAT BELLSOUTH WAS ATTEMPTING AN ABUSE OF MARKET POWER?

A. Yes. First, the complaint was devoid of any factual support. The Consumer Advocate relied on assumptions that were either unsubstantiated and/or irrelevant to a market power analysis. For example, the Consumer Advocate implicitly assumed, but could not demonstrate, that BellSouth's rates were already at (or above) competitive market rates such that any increase in those rates would result in a loss of significant business.[21] The Consumer Advocate also assumed that the proposed price increases were abusive because they (according to the Consumer Advocate) had nothing to do with the costs of the services.[22]

But the issue of rationally evaluating a firm's ability to abuse market power deals with one basic question "can a firm profitably price above a competitive market level?" The answer to this question hinges on whether or not other rivalrous firms will ultimately discipline such pricing attempts. The answer to the market power evaluation does not attempt to presuppose what the competitive market rate is for a specific service nor does the answer depend on a comparison of the proposed rate for the service and the incremental cost of the service. The answer is totally dependent on whether alternative providers currently exist in the marketplace and/or will alternative providers enter the market if the firm's prices exceed a competitive market rate.

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[21] *Id.*

Finally, the Consumer Advocate's complaint implied that BellSouth could abuse market power because it had a dominant market position (i.e., near-monopoly control).[23] As I previously stated, possessing a dominant market share does not necessarily confer to a firm the ability to exercise abusive market power in its pricing activities. This is especially true if the dominant position is due to regulation.[24]

Q. BASED ON YOUR KNOWLEDGE OF THE TELECOMMUNICATIONS MARKETPLACE, HOW DO YOU VIEW THE CONSUMER ADVOCATE'S ALLEGATION THAT BELLSOUTH WAS ATTEMPTING AN ABUSE OF MARKET POWER?

A. The Consumer Advocate's complaint was unfounded and unsupported. For many of the services (operator services, directory assistance, and intra-LATA toll), a significant number of competitive providers and competitive alternatives already exist in the relevant market. Without any further analysis, it is safe to conclude that BellSouth cannot abuse market power in its pricing for these services.

For the other services contained in BellSouth's petition (mostly vertical switch services), the Consumer Advocate provided no review of any of the considerations upon which a

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22 *Id.*

23 *Id.*

24 At least one court has recognized this fact. In *Metro Mobile CTS, Inc. v. New Vector Communications, Inc.*, 892 F.2d 62, 63 (9th Cir. 1989), the Ninth Circuit stated: "Reliance on statistical market share in cases involving regulated industries is at best a tricky enterprise and is downright folly where . . . the predominant market share is the

finding of potential for abuse of market power should be based (i.e., definition of relevant market, determination of lack of substitutable services, and existence of barriers to entry).

SECTION III – INFLATION-BASED INDEX

Q. WHAT IS YOUR INTREPRETATION OF THE PHRASE "INFLATION-BASED INDEX?"

A. I interpret this phrase literally: an "inflation-based index" is an index that is *based on a measure of inflation.*

Q. WHAT INDEX WOULD YOU RECOMMEND THE COMMISSION ADOPT AS THE "INFLATION-BASED INDEX" TO BE USED UNDERSECTION 58-9-576(B).

A. I recommend that the Commission adopt the Gross Domestic Product Chain-Type Price Index ("GDP-CPI"), which is produced by the Bureau of Economic Analysis of the Department of Commerce. This index has been found by the FCC to be the most appropriate index for adjusting telecommunication (and other utilities') revenues for inflation.

In various proceedings, the FCC has reviewed the appropriateness of several inflation-

result of regulation. In such cases, the court should focus directly on the regulated firm's ability to control prices or

based indices (e.g., the Consumer Price Index, the Producer Price Index, the Gross National Product deflator) and, in 1990, settled upon the Gross National Product Price Index ("GNP-PI") as the best index to use as an inflation adjuster for telecommunication prices.[25] In 1995, the FCC replaced the GNP-PI with the Gross Domestic Product Price Index ("GDP-PI") as the appropriate index for measurement of inflation stating that it would "eliminate a needless administrative burden without causing any harm to the public."[26] In 1996, the FCC determined that a new index, the GDP-CPI, is the appropriate index for addressing thresholds for inflation.[27]

Q. DID VERIZON USE THE GDP-CPI TO COMPUTE AUTHORIZED LEVELS OF REVENUE ADJUSTMENTS PER SECTION 58-9-576(B) WHEN IT MADE ITS NOVEMBER 14, 2002 TARIFF FILINGS?

A. Yes.

Q. THE CONSUMER ADVOCATE'S DECEMBER 2, 2002 COMPLAINT REGARDING VERIZON'S SECTION 58-9-576(B) TARIFF FILINGS ASSERTS THAT IT MAY BE APPROPRIATE TO INCLUDE A PRODUCTIVITY OFFSET WHEN DETERMINING AN INFLATION-BASED INDEX. DO YOU AGREE?

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exclude competition."

[25] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, para. 50-54 (1990).

[26] *Price Cap Performance Review for Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, para. 351 (1995).

[27] *Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classification*, Order and Notice of Proposed Rulemaking, CC Docket No. 96-193, 11 FCC Rcd 11716, ("Carrier Classification Order") para. 10 (1996).[This cite needs more information]

A. No. First, as I previously stated, the phrase "inflation-based index" has an absolutely clear meaning – *i.e.*, an index based on a measure of inflation. If the Legislature had intended to incorporate a productivity offset (or any other offset), it would have explicitly mentioned the term productivity or it would have used the term "price cap index," which indices commonly include an offset for productivity. Indeed, price-cap models are frequently referred to as inflation minus X, where X is an estimate of productivity that can be some negative, zero, or positive number.

Second, the use of an inflation-based index in Section 58-9-576(B) only applies to changes in the rates for flat-rated local exchange residential and single-line business services. As far as I know, telecommunication-related productivity studies have never been performed at a service-specific level. Historic productivity estimates were based on an analysis of how "all" inputs are used to produce "all" the firms' outputs. Attempting to evaluate productivity for only basic exchange services would therefore be an irrational endeavor.

Third, it must be understood that historically productivity factors were just a blunt regulatory tool (and also a highly contentious regulatory tool) that were used in many price-cap plans to guide the transition from a purported near-monopoly market to a competitive market. The competitive landscape is significantly different than it was when productivity factors were introduced: ILECs have felt the effects of the competitive marketplace and the resulting revenue reductions, which exceed the amount a monopoly-

based productivity factor would produce.

Lastly, many of the existing rates established for basic residential and business exchange services are significantly below competitive market levels (i.e., for the most part, they are supported services). The thought that future price changes for these services should reflect a reduction based on an immeasurable and inappropriate productivity offset is antithetic to rational competitive pricing objectives and antithetic to the development of competitive alternatives. The objective for these services should be to move their price *toward* competitive market levels, not to move them farther away.

For all these reasons, the Commission should summarily dismiss any notion of incorporating productivity offsets into the definition of an inflation-based index, to be used to guide the pricing of basic exchange services, as absolutely irrational as well as anti-competitive.

Q. HAS THE FCC EVER MADE AN INTERPRETATION OF WHAT IT MEANS TO ADJUST A CARRIER'S REVENUES FOR INFLATION?

A. Yes, Section 402(c) of the 96 Act mandated that the FCC annually adjust carriers' revenue requirements for inflation to determine how carriers should be classified for accounting purposes as well as requirement to file cost allocation manuals. But the 96

Act did not specify how the FCC should measure inflation in adjusting references to carrier's revenues. This issue is identical to the definition of an "inflation-based index" which would be used to determine an ILEC's inflation-adjusted basic service revenues. The FCC appropriately interpreted the 96 Act's reference to inflation as requiring the use of a generally available "inflation index." The inflation-based index the FCC elected to employ was the GDP-CPI. At no time did the FCC entertain interpreting an adjustment of revenues based on inflation as even implying that some estimate of productivity should also be included.[28]

Q. DOES THE FCC PRESCRIBE THE USE OF THE GDP-CPI FOR DETERMINING ALLOWED PRICE MOVEMENT IN ANY OTHER UTILITIES?

A. Yes, the FCC allows cable operators to adjust the non-external cost portion of their rates for inflation based on quarterly GDP-CPI figures.[29] Again, the FCC does not prescribe that the definition of the effect of inflation on the cable industry should include some measure of productivity.

Q. WHEN VERIZON DECIDED TO ELECT ALTERNATIVE REGULATION PURSUANT TO SECTION 58-9-576, WHAT WAS ITS INTERPRETATION OF THE LANGUAGE "INFLATION-BASED INDEX?"

[28] Carrier Classification Order.

A. Verizon's decision was based on the language's plain meaning, which should not be misconstrued to require the application of a productivity index.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

[29] Thirteenth Order on Reconsideration in MM Docket No. 92-266, FCC 95-397, 60 FR 52106 (October 5, 1995).